THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

NUMBER 410 **NOVEMBER 2008**

COLLATERAL, DAMAGED

There are no words to describe the ferocity of the equity market decline, the credit market convulsions and the across-the-board policy blitz following the Lehman Bros. bankruptcy. Even those of us who are quite familiar with the history of financial instability, and hence have been warning about the systemic risks inherent in the new financial architecture for some time, cannot help but be shocked by the wanton destruction of financial wealth in recent weeks. In the sequence developed in Charles Kindleberger's useful book on such episodes, *Manias, Panics and Crashes*, we appear to be rapidly moving through the panic phase, in which investors and creditors attempt at any cost to extract themselves from positions that were once viewed as brilliant trades or wisely crafted loans, and into the revulsion phase. During the revulsion phase, entire classes of financial instruments and investing methods are brought into question and shunned, as if they had never been entertained as serious financing vehicles or investment approaches in the first place. Creditors, in particular, become especially gun-shy about taking on even normal business risk, and liquid assets are often hoarded by both financial and nonfinancial agents. Economic activity is rarely left unscathed as a result.

Clearly, the earlier assessment offered by both Wall Street professionals and many policymakers that the subprime mortgage mess was a minor dislocation that could be readily contained has proven well wide of the mark. We now have a global conflagration on our hands, with a sharp recession in the G-7 nations a near certainty, and substantial subpar growth in store for the developing nations, as well. What was once viewed as an especially resilient structure — one that weathered the 1998 Long-Term Capital Management crisis; the unraveling of the dot-com bubble; the severe stress test of structured finance with the Enron and WorldCom revelations; and, later, the GM derating challenges — is now understood to have been a fundamentally deranged and dramatically overleveraged financial system.

The phrase "systemic crisis" now rolls seamlessly off the lips of policymakers who previously dared not even utter the word "bubble." The flaws being revealed in the existing financial structure were something Dr. Kurt Richebächer understood from the very beginning, but we suspect even he would find the magnitude of the credit convulsion under way overwhelming. In addition, the scale and the scope of policy initiatives taken to try to contain the damage have proven nothing short of breathtaking — no doubt, these have already trespassed the limits of Dr. Richebächer's worst nightmares. The rules of the financing game are being torn up and rewritten before our eyes, and it is important to seek out the consequences of these dramatic changes — especially the unintended ones — in order to adequately prepare for the challenges ahead.

In the following *Richebächer Letter*, we will do our best to pierce the fog of financial war — and that, indeed, is what even professional investors feel they have been operating under in recent weeks — using the unique principles and vantage points that Dr. Richebächer was able to develop during his many years of earnest and painstaking macrofinancial analysis. As always, we will treat his contribution as a living legacy, knowing that Dr. Richebächer drew from many rare sources and was never afraid to forge his own analytical route well off the beaten path.

We cannot help but mention that were Dr. Richebächer still alive today, he would feel deeply vindicated. But rather than rest on his laurels, or fall prey to the fear now paralyzing many professional investors, he would be pushing through the chaos of recent weeks and forging a correct diagnosis of the credit convulsion at hand, and then outlining a coherent and independent view of the next stages of this financial crisis and, finally,

depicting its likely resolution.

To understand the current conjuncture, one must be willing to fully grasp the importance of credit conditions, financial asset prices and portfolio preferences to real economic outcomes. As we have mentioned before, in mainstream economics, especially new classical economics, there is little room for such considerations. Production is described as largely a technical engineering problem: The quantity of capital in place and the quantity of labor available in the labor force determine — along with labor productivity, real wages and natural resource endowments — the level of economic activity toward which producers and households will tend to gravitate.

Finance has no significant place in these so-called production functions found in mainstream economics. Ludwig von Mises and the Austrian School economists, as well as J.M. Keynes and some of the post-Keynesian School economists, argued vehemently against this abstraction away from financial influences on economic outcomes. Not only did they live through times that emphatically suggested otherwise, but their way of understanding economic activity always placed money and credit considerations alongside real supply-and-demand considerations in determining economic outcomes — a perspective with which most entrepreneurs and businessmen would tend to concur. Dr. Richebächer drew heavily from these streams in his analysis of real-world economics. As the world is undoubtedly about to discover how much finance matters to economic growth, the lens that Dr. Richebächer employed may be especially useful and relevant now.

Simply put, the ferocious unwinding of leveraged speculation across many asset classes — residential real estate, structured finance, corporate bonds, foreign exchange, commodities and equities — that was accelerated by the bankruptcy of Lehman Bros., a major U.S. investment bank, has dramatically reduced the net worth positions of households, firms and financial institutions. Margin calls and hedge and mutual fund redemptions have subsequently induced forced asset sales. A sharp surge in liquidity preferences across individual and institutional portfolios has amplified the collapse in asset prices further. Borrowing capacities have been deeply undermined as capital cushions have shrunk and lender willingness to roll over existing credits, never mind to issue new ones, has been seriously impaired.

Spending plans of firms and households are contracting in response to declining net worth, rising costs of credit for interest rates relevant to the private sector and declining availability of credit to the private sector. Policy measures to buttress the capital positions of key financial intermediaries have been announced, extension of deposit guarantees have been implemented and massive liquidity injections by central banks both domestically and abroad have been introduced to meet the tremendous demand for liquid assets from investors and creditors.

THE RICHEBÄCHER LETTER

In Memory of Dr. Kurt Richebächer

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We suspect the next steps will emphasize measures to stabilize home prices through targeting mortgage rates, with the objective of reducing the overhang of existing home supplies from foreclosures. In addition, with the U.S. export engine likely to cool substantially, capital spending and commercial construction headed into recession and profit income and retail sales revenue already deflating, both passive and active fiscal stimulus are likely to be brought to bear to avoid a full-blown debt deflation. Even with these measures, the net result of the credit contraction under way is likely to be a recession that rivals the 1980–2 experience: A 2–3% contraction of real GDP in 2009 is not out of the question, by any stretch of the imagination. Beyond that, as mentioned in last month's letter, we suspect a highly regulated, stripped-down financial system will be left standing, one upon which it will be much harder to construct asset bubble-driven growth.

In the Austrian approach, entrepreneurs exploit uncertainty by pursuing innovation; organizing production and distribution of new products or new technologies; and creating mutually beneficial contracts with suppliers, employees, financiers, distributors and customers, in order to reduce the degree of uncertainty.

TRIGGERING THE CREDIT CONVULSION

> *In the real world, acting man is faced with the fact that there are fellow men acting on their own behalf as he himself acts. The necessity to adjust his actions to other people's actions makes him a speculator for whom success and failure depend on his greater or lesser ability to understand the future. Every action is speculation. There is in the course of human events no stability, and, consequently, no safety.*
>
> — Ludwig von Mises, *Human Action*

Uncertainty is an unavoidable attribute that all economic agents face. As reflected in the quote above, uncertainty is not simply an artifact of the natural world, with floods, earthquakes and unpredictable weather. It is equally an artifact of individuals making decisions strategically, in the face of an unknown and sometimes unknowable future.

In the Austrian approach, entrepreneurs exploit uncertainty by pursuing innovation; organizing production and distribution of new products or new technologies; and creating mutually beneficial contracts with suppliers, employees, financiers, distributors and customers, in order to reduce the degree of uncertainty. The presence of uncertainty also tends to favor more adaptive, market-based economic arrangements than rigid planning structures.

In the approach of Keynes, uncertainty is especially relevant to the capital spending and investment portfolio decision-making process. In economies in which money does not take the form of a produced commodity like gold, entrepreneurs and wealth holders will often cope with uncertainty by trying to hold more liquid assets. In the face of uncertainty, liquid assets not only preserve the money value of wealth, but because liquid assets are either acceptable as a means of final settlement or can be transformed into same in short order, they leave entrepreneurs and investors free to reassess and act on their options as they arise. Liquidity provides optionality, and also reduces exposure to the loss of money wealth.

In the case of the current credit convulsion, we believe the combination of a high degree of leverage within the financial system itself (depicted in last month's letter), along with the development of highly complex structured finance vehicles trading in the opaque, self-regulated, over-the-counter markets that became increasingly illiquid as damage to the housing market was revealed, introduced an unusually high degree of solvency uncertainty across the financial system. The publicly funded takeover of Bear Stearns, the failure of

IndyMac and the renationalization of the government-sponsored entities Fannie Mae and Freddie Mac all contributed to an ever-increasing climate of fear among equity investors, creditors and counterparties across the financial arena.

The failure of Lehman Bros. proved to be a tipping point of enormous consequence against this backdrop of solvency uncertainty. Treasury Secretary Henry Paulson, Fed Chairman Ben Bernanke and Federal Reserve Bank of New York President Timothy Geithner chose a particularly treacherous time to adopt a rather Austrian solution to the current financial crisis. Money market mutual funds holding Lehman commercial paper were immediately suspect, and institutional money market funds faced a run. Hedge funds dealing through Lehman's prime brokerage desk found their cash positions frozen and tied up in the bankruptcy proceedings. Institutional investors began asking who would be the next to fall and pulled accounts from Goldman Sachs and Morgan Stanley. Investor adaptations to the Austrian solution appeared to spread the financial distress like a self-fulfilling prophecy.

Once solvency uncertainty spreads across various financial institutions, many banks and nonbank institutions can find it difficult at best to roll over short-term financing instruments that they require to position assets on their balance sheets. We initially saw this refinancing risk emerge with the revelation that many financial firms were using the asset-backed commercial paper (ABCP) market in off-balance sheet structures known as structured investment vehicles (SIVs) that were holding various structured finance vehicles like collateralized debt obligations (CDOs) in August of last year. ABCP could not be rolled over, and either backup bank credit lines had to be used to maintain the short-term financing or the SIV assets had to be brought back on the balance sheets of the sponsoring financial institutions. Decades ago, Hyman Minsky described before Congress the nature and implications of such disruptions to short-term financial channels:

> *The typical problems of a refinancing crisis occur when the "normal" liabilities cannot be issued either because the borrowers cannot meet the market terms… or because a market that has been counted on is not working normally. When this occurs, either assets have to be sold or the borrowing unit cannot fulfill obligations to the prior lenders, who may seek to withdraw their funds in a "run." Such a failure of borrowers to perform in any significant market means that throughout the credit markets, a more skeptical view of permissible liability structures and income prospects begins to rule… Such a shift in preferences… makes the terms of debt financing… more onerous. This leads to a sell-off of inventories and to cutbacks in investment, driving the economy toward a recession/depression.*

In essence, what we have just witnessed is a run on the new financial architecture, with a multitiered unconventional policy response designed to keep the core of the credit system propped up.

While Paulson's troubled asset relief program (TARP) proposal was originally described as a program targeted at removing illiquid asset holdings that were ostensibly clogging new lending from the financial system, this can only have been designed from the start as a smoke screen.

RESPONSES TO THE CREDIT CONVULSION

While Paulson's troubled asset relief program (TARP) proposal was originally described as a program targeted at removing illiquid asset holdings that were ostensibly clogging new lending from the financial system, this can only have been designed from the start as a smoke screen. For decades before securitization,

banks have held illiquid assets on their balance sheets — they were called loans. Holding illiquid loans did not prevent banks from expanding their balance sheets through new lending. The liquidity of the assets held by banks was never the issue. Rather, the price of these illiquid assets, and the implications of the impaired value of these assets for the capital positions of financial institutions, was always the issue. The issue was always about solvency, not liquidity.

From the start, we suspected the purpose of TARP was to bid up the prices of illiquid assets held on bank and nonbank balance sheets. By bidding high (or, in Chairman Bernanke's, parlance, bidding above distress sale prices, but below hold-to-maturity prices), the Treasury hoped to relieve the pressures that mark-to-market accounting had been placing on these balance sheets as these assets fell in value or became impaired. Since capital or net worth is simply the difference between the values of assets and the values of liabilities, any action that lifts the value of assets will tend to rebuild the capital or net worth of a financial institution.

We believe TARP was initially designed as a backdoor public recapitalization of the largest firms in the financial sector. Having seen the opening moves of the now established TARP, which involved doling out $250 billion of the initial $700 billion allocation to establish preferred equity positions in several large firms, we are convinced we had the intent right.

Moving to the monetary policy response, it is not always recognized that the capacity of the Fed to expand its own balance sheet is technically infinite. For any central bank with a sovereign currency — that is, convertible on demand only into itself, rather than a fixed quantity of a produced commodity or a fixed quantity of another currency — the usual budgeting conventions cease to apply. The monopoly supplier of money cannot run out of money. When purchasing an asset from private or public sector agents, such a central bank merely credits the bank account of the seller and takes possession of the asset sold. Unlike most other agents in the economy, the Fed, consequently, does not need to raise money in order to spend money.

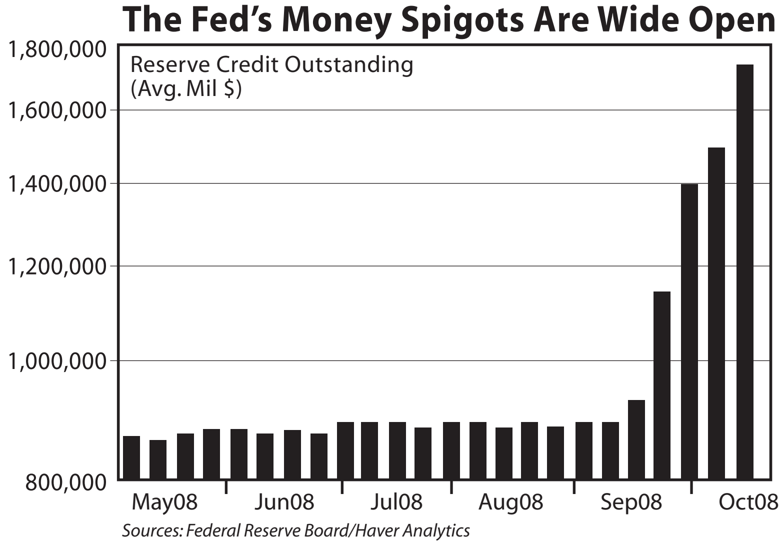
In a period of solvency uncertainty — an episode extreme enough to lead to the disruption of even short-term financing arrangements — the liquidity preference of the private sector becomes equally extreme. Liquidity preference is aggravated even further if solvency uncertainty and financing disruptions are accompanied by falling asset prices in less-liquid categories, like real estate and equities. As each investor attempts to reduce his exposure to less-liquid asset classes and to accumulate liquid assets that can hold steadier money values, the prices of less-liquid assets must fall for markets to clear. This takes us straight into the paradox of deleveraging discussed in last month's letter. At a minimum, it can lead to asset price overshoots. At worst, it can beget full-blown debt deflation, as Irving Fisher first experienced and then theorized over a lifetime ago.

Two decades ago, an up-and-coming academic caught a glimpse of how such a process might unfold while he was analyzing the consequences of the leveraged buyout corporate debt boom. While this following sequence starts with distress among nonfinancial firms that backs up into the banking system, the analysis holds equally true in reverse.

> *Bankruptcies or financial distress among some major firms could contribute to a general liquidity crisis in several ways. Perhaps most important would be the fear of the complete freeze of the firms' productive capabilities… In such a situation, the liquidity of nonfinancial firms and of banks would be closely intertwined, because, for example, most firms back their commercial paper issuance with bank lines of credit, which would provide relief in a crisis only if banks remained liquid. This particular scenario is speculative. (Bernanke, Ben and Campbell, John, "Is There a Corporate Debt Crisis?"* Brookings Papers on Economic Activity*, 1988, No. 1)*

One way to break this vicious cycle is for the central bank to bid for less-liquid assets held by the private sector while increasing the supply of liquid assets in the system. Prior to the Lehman failure, the Bernanke Fed was reluctant to expand its balance sheet in such a fashion. While the Fed was accumulating less-liquid assets

from the private sector — as with the Bear Stearns portfolio — it was at the same time selling Treasuries from its portfolio in order to avoid a large net injection of money into the system. Clearly, as displayed at right, the Fed has tossed that playbook right out the window. In an unprecedented fashion, the Fed's balance sheet has doubled in size in the course of a mere month!



With the Fed now literally flooding the system with liquidity, there is a better chance for less-liquid asset prices to stabilize, and therefore for the subsequent erosion of household, business and financial sector net worth positions to stabilize, as well. An extreme surge in liquidity preference has been met with an extreme increase in liquidity provided by the Fed.

While the immediate question is whether the enormous injection of liquidity by the Fed is, in fact, sufficient to overcome the effects of rapid deleveraging and risk disengagement in the financial sector, there must be a longer-range set of questions posed by these unprecedented moves, as well. On the other side of the credit convulsion, and especially on the other side of the recession that we believe is already under way, the Fed must be willing to remove this liquidity in an orderly fashion, or it will surely provide the raw material for the next credit bubble.

In addition, while foreign investors may applaud the short-term benefits of the asset price stabilizing effects of these moves, we cannot imagine foreign owners of U.S. liabilities are terribly thrilled to see the Fed exploding the size of its balance sheet. This, after all, is precisely the pattern by which nations with large external net debtor positions have attempted to inflate, or even hyperinflate, their way out of their debt obligations. In this regard, the recent announcement by the Fed that it is willing to provide unlimited currency swap lines with selected foreign central banks must be especially alarming to foreign holders of U.S. dollar-denominated liabilities. The Fed appears to be backstopping the European Central Bank, which in turn is addressing the inability of its financial sector to roll over dollar-denominated funding.

While the dollar strengthened in the weeks following the Lehman Bros. failure, and dramatically so in some cases, we have to wonder whether much of this was simply hedge funds covering their various short dollar bets as they were forced to deleverage their own balance sheets in the face of prime brokerage margin calls and expected redemptions. Accordingly, we would recommend being especially vigilant on the dollar exchange rate in the months ahead, and as mentioned briefly below, we would suggest that readers explore possible dollar exit strategies in advance.

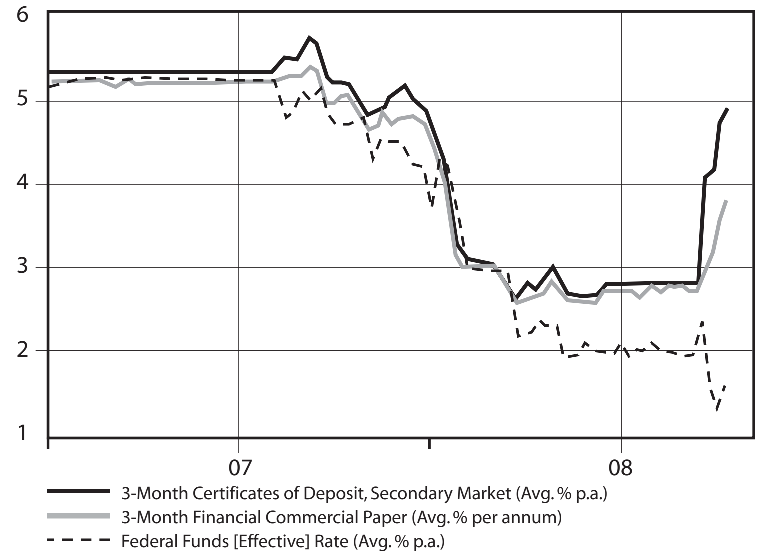
To the extent the Fed is swapping newly created liquid assets for less-liquid assets held on private sector balance sheets, it is not immediately obvious that these liquid assets will be subsequently spent on produced goods and services. We believe, however, that having unleashed this flood of liquidity, the Fed will next target the reduction of specific private market interest rates through more pinpointed interventions. In a November 2002 speech outlining some of the unconventional policy measures the Fed would likely invoke in the face of a debt deflation threat, Chairman Bernanke described the following option in some detail.

> *[A] second policy option, complementary to operating in the markets for Treasury and agency debt, would be for the Fed to offer fixed-term loans to banks at low or zero interest, with a wide range of private assets (including, among others, corporate bonds, commercial paper,*

bank loans and mortgages) deemed eligible as collateral. For example, the Fed might make 90-day or 180-day zero-interest loans to banks, taking corporate commercial paper of the same maturity as collateral. Pursued aggressively, such a program could significantly reduce liquidity and term premiums on the assets used as collateral. Reductions in these premiums would lower the cost of capital both to banks and the nonbank private sector, over and above the beneficial effect already conferred by lower interest rates on government securities.

Financial sector commercial paper, as well as bank CD rates, spiked higher after the Lehman failure, despite the Fed flooding the system with liquidity and the recent lowering of the fed funds rate. In addition, many state and local government entities are facing sharp increases in funding costs as they roll over existing debt. Until and unless the Fed is able to pull these interest rates down, the flow and the price of credit will remain prohibitive, and hence will surely deepen and elongate the recession. As we write, some progress is already visible in declining financial commercial paper yields, and even declines in three-month Libor rates as well, although these have proven more begrudging.

Bank's Interest Rates Pull Away From the Fed



Source: Federal Reserve Board/Haver Analytics

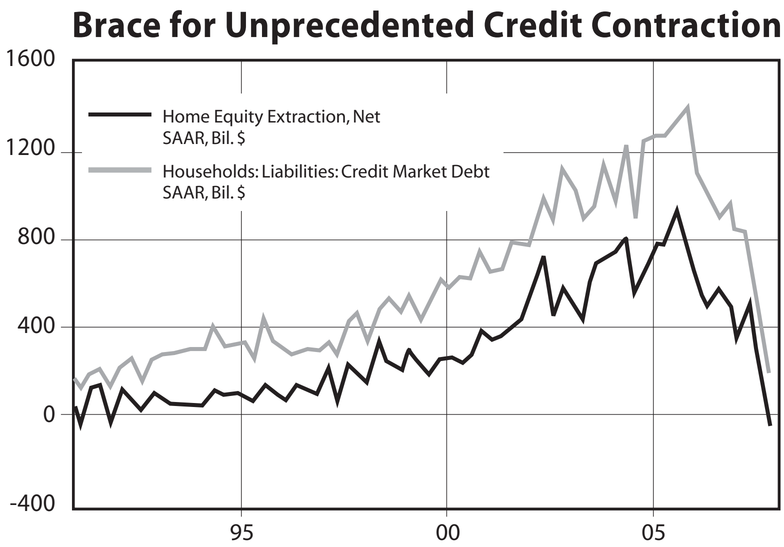
Once short-term money market rates are brought down, we believe attention will be focused on lowering mortgage rates. Already, the GSEs have been instructed to purchase $40 billion per month in mortgage-backed securities (MBS). Treasury now has the capacity to purchase MBS, and we would not be surprised to see the Fed focus its balance sheet expansion on this asset class. We believe the objective here will be to reduce mortgage rates sufficiently so that mortgage refinancing activity can ramp up. Home price stabilization must be the ultimate objective, as both the housing overhang from foreclosures and the question of the value of structured financial vehicles are unlikely to be addressed without it.

CONSEQUENCES OF THE CREDIT REVULSION

Never before has there been such a worldwide collapse over almost the whole field of the money values of real assets as we have experienced in the last two years. And finally, during the last few months — so recently that the bankers themselves have, as yet, scarcely appreciated it — it has come to exceed in very many cases the amount of the conventional "margins." In the language of the market, the "margins" have run off. The exact details of this are not likely to come to the notice of the outsider until some special event — perhaps some almost accidental event — occurs which brings the situation to a dangerous head. For, so long as a bank is in a position to wait quietly for better times and to ignore meanwhile the fact that since the security against many of its loans is no longer as good as it was when the loans were first made, nothing appears on the surface and there is no cause for panic. Nevertheless, even at this stage, the underlying position is likely to have a very adverse effect on new business. For the banks, being aware that many of their advances are in fact "frozen" and involve a larger latent risk than they would voluntarily carry, become particularly anxious that the remainder of their assets should be as liquid and as free from risk as it is possible to make them.

— J.M. Keynes, *Essays in Persuasion*, 1931

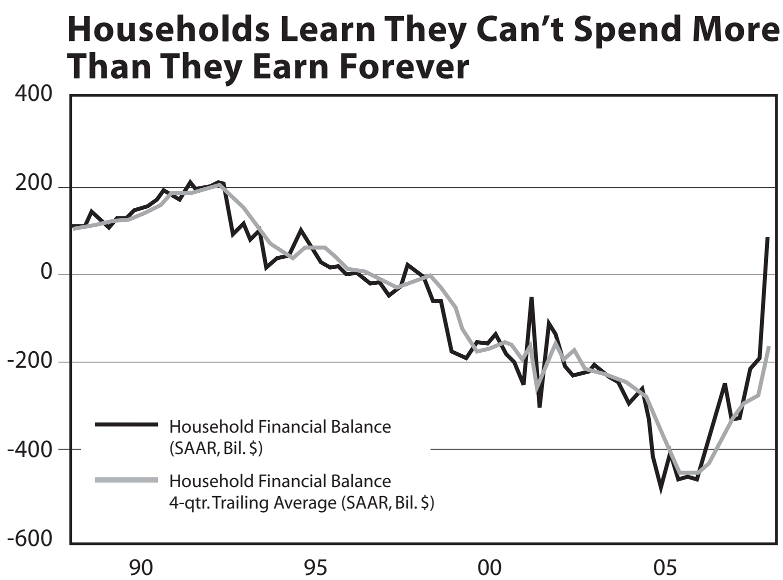
By the time the second quarter of this year ended, the flow of household borrowing had already collapsed to levels last seen during the credit head winds of 1991–3. Leading the charge down was the first contraction in mortgage equity withdrawal in 16 years. That is to say, before the Lehman bankruptcy, the waterfall in global equity prices and the spike in financial commercial paper yields and bank CD rates, credit flows to the U.S. household sector had virtually ground to a halt. Knowing this to be the case, it is entirely possible that the household credit contraction in the remainder of 2008 will prove completely unprecedented in the postwar period.



The reason this is of the essence, as explained in prior letters, is that the U.S. household sector became accustomed to running its own deficit. Borrowing against the net worth accumulated from appreciating equities during the dot-com bubble, and then real estate during the housing bubble, households managed to spend more than they were earning for over a decade. While Federal Reserve Flow of Funds data are dangerously volatile and subject to large revisions, it appears this household deficit spending spree came to an abrupt close in the second quarter of this year. The decade-long party appears to be over, and a new frugality has rushed into its place.

From a long-run perspective, the return of the household sector to a position of net saving is healthy, especially given the current demographics. From a shorter-run perspective, the transition is bound to be a challenge. The first phase of the improvement in the household sector financial balance had everything to do with the collapse in new home purchases. The second phase has everything to do with the reversal of retail sales growth. One undisputed victim of the household credit revulsion is retail sector revenue growth, which along with corporate profit income, is now deflating. Deflating private income flows are generally neither good for employment growth nor are they good for private debt servicing. The feedback loops now entrained by the new frugality have a particularly nasty look.

The new frugality may have a deeper root, however, one quite familiar to Dr. Richebächer. Last month, we noted the deep confusion between leverage and liquidity that developed among professional investors under the auspices of the new financial architecture. More leverage may bring more buying power to any one investor, which may create the perception of more liquidity in a given market, but it is not, by any means, the same as an increase in liquid assets in the system as a whole.



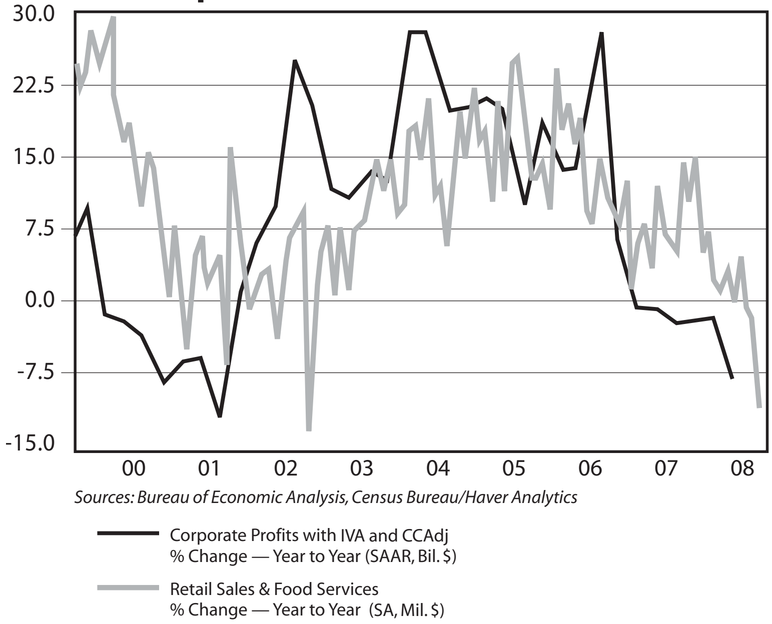
Source: Haver Analytics

A deeper confusion across the populace, however, deserves to be pointed out, and that is the difference between

financial wealth and productive capacity. An increase in the money value of financial assets is not to be confused with an equal or proportional increase in the productive capacity of an economy. While there is no doubt that an increase in the money value of financial assets can encourage the expansion (and sectoral distortion) of the productive capacity of the economy — particularly its tangible capital equipment and structures — the two are not equivalent.

In a sense familiar to the classical economists like Adam Smith, and in a sense still emphasized today by the Austrian School, the wealth of a nation must ultimately be measured by the capacity to produce goods and services both in the present and the future. The money value of financial assets, after all, is little more than the ability of that money to eventually claim control over present and future products (although Thorstein Veblen and others would argue social status is equally conferred by money wealth). A 2006 keynote speech by William R. White, formerly of the Bank of Canada, highlighted this distinction from decades ago, but long since forgotten.

More Household Saving Means Lower Sales and Corporate Profits



Sources: Bureau of Economic Analysis, Census Bureau/Haver Analytics

> *As a corollary, I also agree with M.J. Bailey, who stated much earlier that this lifetime flow of produced goods and services depends on the production possibilities of the society and that "when no change at all has occurred in physical capital, land or labor or in their present or prospect productivities… no new productivity or wealth has appeared to make possible any increase in future consumption."*

The significance of Bailey's insight cannot be underestimated. If the tangible capital stock, along with other productive resources, is not built up pari passu during the course of an asset bubble, then the attendant surge of financial wealth is essentially illusory. While Bailey states the extreme case, the insight holds true in any bubble in which the increase in financial wealth outstrips the increase in productive capacity.

Dr. Richebächer was painfully aware of this paradox of asset bubbles. The accumulation of present and future buying power during an asset bubble could only lead to two things when the tangible capital stock failed to keep pace with the appreciation of financial values. Either inflation would emerge in the present or future as this spending power was exercised against a productive capacity that had not kept pace, or a sustained current account erosion would prevail as spending power was met by productive capacity put in place in other nations.

White, in his poignant speech to the Irving Fisher Committee Conference at the Bank for International Settlements on Aug. 31, 2006, near the close of his career, took this one step further. Titled "Measured Wealth, Real Wealth and the Illusion of Saving," White's speech emphasized what may happen when households use portfolio appreciation as a reason not to save out of income flows:

> *Viewed from this perspective, the suggestion that countries benefiting from large increases in measured wealth, largely because of asset price increases, need no longer save out of income in the traditional way looks not only questionable, but dangerous. Saving associated with illusory wealth increases is illusory savings. The end result must be a lower level of domestically*

> *owned capital and an associated lower standard of living over time. Moreover, such spending can contribute to current account deficits with all the associated potential for mischief noted above. And to this must be added the diminished political authority associated with countries that become increasingly indebted. History has many lessons to teach us in this regard.*

Confusing appreciating financial asset prices with enhanced productive capacity is bad enough; confusing appreciating financial asset prices with saving simply compounds the illusion. For many years now, Americans have implicitly sought to avoid the consequences described above — a lower level of domestically owned capital as foreign claims accumulate on the U.S. capital stock through perpetual trade deficits, and an associated lower standard of living over time as domestically generated income flows are siphoned off to foreign owners — by pursuing serial asset bubbles that enhanced their financial wealth while distorting, as detailed in the last letter, their tangible wealth in the form of the productive capacity of the installed capital stock. With the collapse of the new financial architecture, this jig appears up.

White clearly foresaw the consequences of a household deficit spending spree built on the back of a housing bubble. These final passages from his speech literally traced out in advance the consequences spelled out in the charts earlier. As White puts it so clearly, revealing his careful study of financial stability during the course of his career, the assets have disappeared, but the liabilities remain to be serviced.

Unfortunately, we are not in a position to offer direct portfolio advice to the readers of* The Richebächer Letter. *However, given the extraordinary state of affairs, it may be helpful to consider the following possibilities in a world operating far from the norm.

> *If higher house prices do induce an increase in spending, then the households that have done so finish with fewer assets or more liabilities than they would otherwise have had. In practice, debt levels have trended sharply higher in recent years as consumers have remortgaged their existing house at higher levels or have traded up. In spite of record low interest rates in recent years, debt service levels (as a proportion of disposable income) have also risen sharply and now stand at record levels in a number of industrial countries.*
>
> *Should house prices fall, which is one way to re-establish a more normal ratio of house prices to rents, then the payback referred to earlier will be primarily at the expense of homeowners. It will then be evident that the wealth they spent was illusory; the assets have disappeared, but the liabilities linger on. This would have negative implications for spending. However, even were prices only to stop rising, the growth rate of consumption would be affected, due to the absence of the earlier stimulus of rising prices.*

NAVIGATING A CREDIT CONVULSION

Unfortunately, we are not in a position to offer direct portfolio advice to the readers of *The Richebächer Letter*. However, given the extraordinary state of affairs, it may be helpful to consider the following possibilities in a world operating far from the norm. Again, these are perspectives drawn from analysis above, and they are offered as suggestions to help you begin your own thinking about positioning in what is proving to be a very disorienting time.

1. With respect to personal finances, an environment like that above requires as a first step bringing household expenditures in line with income. Rolling over debt is likely to prove more difficult for

households in the days ahead. Once household spending is no longer reliant on credit, reducing expenditures to pay down high-interest-rate consumer debt may prove to be one of the best investments available. Repairing credit scores might also prove a timely investment right now, as banks are likely to further tier customers, even after the credit convulsion has passed, and homeowners will want to be in good shape if and when mortgage rates come down enough to allow another refinancing wave to develop. For those more concerned about systemic failure in the U.S. financial system, we can only suggest you consider the services of outfits like EverBank and the Sovereign Society, to explore options for diversifying your portfolio exposures to different nations.

2. With equity markets down over 40% peak to trough, much of the damage is likely done, and if anything, price overshooting to the downside should reveal some selective bargains. Having said that, maximum earnings risk lies straight ahead, and very few portfolio managers have lived through a full-blown recession. Deep value investing styles — harkening back to the days of Benjamin Graham, even — may help identify possible buy candidates. High-dividend-yield stocks are only a place to start, since many dividend payments may be reduced as corporate profits are challenged in the quarters ahead. Low-debt, high-cash-holding and high-free-cash-flow companies should be favored, as well as companies with dominant market shares that may be able to take advantage of weaker competitors. Steady earnings growers, especially steady top-line revenue growers often found in the consumer staples, health care and utility sectors, are generally better placed to ride out an economic storm of this magnitude. Beyond that, should a serious public investment program be initiated to confront a deep and abiding recession, we would not be surprised if water and energy infrastructure plays take precedence over the usual bridges and roads packages.

3. On fixed income, yield has gotten very scarce on the short end of the Treasury curve. As in Japan, we suspect even though nominal yields on the longer end of the Treasury curve are quite low, they will be going lower as banks arbitrage out the yield curve. Commercial paper and CD rates provide higher yields for those preferring to remain in shorter-duration vehicles, but you will want to be sure the issuer is either able to take advantage of existing Fed and Treasury programs to inject liquidity or strong enough to stand on its own. Once the harsh economic conditions are more visible (which will probably take place well into Q1), the yield spreads of municipal bonds and corporate bonds, which are at historical extremes, may be worth reaching for.

4. On commodities, the great unwinding of leveraged speculative long positions by hedge funds (especially those facing redemptions or high-water marks), the likely revulsion trade out of this asset class by endowments and pensions funds plus the failure of global decoupling and the downside risk of an outright debt deflation all weigh against this asset class. Beyond watching for those commodities that overshoot in price below normal production costs, gold as a hedge against systemic failure or a rising suspicion of fiat currencies as governments respond in unprecedented ways to financial crisis and its economic aftermath may be considered.

5. On currencies, given the dramatic expansion of the Fed's balance sheet, one would have reasonably expected equally dramatic dollar weakness. Instead, the unwinding of commodity bets has led to similar dramatic falls in commodity currencies. While overdone in the short run, we suspect this is not through yet, at least not until professional investors can better gauge the depth and duration of the global slowdown. Concerns over whether the euro, an odd duck at best in terms of currency systems, will survive the strains ahead make this a less likely place to take a stand, and some of this is already reflected in the sharp appreciation of the dollar against the euro. In the meantime, the unraveling of the yen carry trade has boosted the yen against the dollar, even though recession dynamics are already very visible in Japan and yields remain extremely low.

CONCLUSION

The collapse of asset prices since the Lehman Bros. bankruptcy heightens and aggravates many of the adverse macrofinancial dynamics identified and explored in prior *Richebächer Letters*. The sharp shift in portfolio preferences toward liquid assets has been met by an unimaginable injection of liquidity by the Fed and other central banks, along with other unconventional steps to extend deposit guarantees and publicly recapitalize banks. Private market interest rates have as yet shown relief only in the very shortest-term maturities, and we expect more active targeting of mortgage rates by the Fed will ensue. 2009 should be a year when yields on cash instruments and Treasuries are trashed.

Given the damage to private sector net worth since the sharp reduction in credit flows to the household sector in the second quarter, we doubt lending growth to households and businesses will revive until late in 2009. At best, crucial short-term credit flows to nonfinancial firms will be secured through Fed intervention in the commercial paper market. As a consequence of the credit situation, the likely deterioration of private income flows and the TARP response, banks are apt to try to borrow at short-term interest rates and lend at longer-term Treasury maturities until there is more evidence that the housing market is stabilizing and the economy is closer to bottoming out.

Diminished business and household net worth, combined with tightened credit conditions, are likely to place the U.S. economy on a harder landing trajectory, one unseen since the 1980–2 recession. Collateral across the board has been damaged. A contraction of real GDP by 2% is not out of the question even with a large fiscal response, but keep in mind that with Lehman's failure, inventory reductions had already begun before the September tipping point and housing as a share of GDP had already dropped to prior-recession lows. Of course, we would have preferred a different outcome, one in which the concerns Dr. Richebächer raised over the years had not only been raised, but listened to and regarded with the respect that they were always due.